

factors affecting OPEB costs, and LEC control (in the FCC's view) over investment decisions. Indeed, the TBO represents the OPEBs "promised" to employees and retirees before SFAS-106 took effect, and under all the circumstances we lack substantial control. The accounting change impacts decisions previously made. For example, the TBO is based upon retirees as of January 1, 1993 and their past service, as well as on previously established actuarial assumptions, and constraints, etc. Further, unlike depreciation prescriptions, changes in the USOA or GAAP -- the type of change involved here -- have explicitly been identified by the FCC as eligible for exogenous treatment.<sup>28</sup> If the FCC were to mandate a USOA/GAAP accounting change for depreciation, or promulgate policies actively affecting plant lives and retirements, then those changes would be eligible for exogenous treatment.

Fourth, having been required to incur TBO costs, to the limited extent we could control the level of these costs, we have done so. The NTCs have substantially limited the level of TBO costs. For example, in the NTCs'

92-101 Direct Case.<sup>29</sup> These assumptions include a cap -- based on the medical/dental Consumer Price Index (CPI) -- on employer contributions to management health care costs, and a fixed dollar cap on employer contributions to nonmanagement health care costs which is based upon projected medical trend rates through 1995.<sup>30</sup>

NYNEX has been quite active in efforts to control medical costs. As early as July 1985, the NTCs implemented a benefit cost sharing plan (called "Flex Plus") for management employees and retirees whereby NYNEX ceased to be the sole contributor to the offered benefits. This limits the NTCs' OPEB liability significantly. The cost sharing plan is still in effect with management employees required to bear a greater share of the escalating costs every year. NYNEX has actively encouraged preventive medical care for all employees through participation in health maintenance organizations (HMOs) and preferred provider arrangements covering care of mental health, chemical dependency, etc. Also, NYNEX has instituted mail order prescription drug programs, second opinion requirements, increased policy deductibles and co-payments, etc. All these factors are why the NTCs presented a conservative, aggressive assumption approach that

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<sup>29</sup> NTCs' Direct Case filed June 1, 1992, Attachment E, Attachment H. The assumptions used in the Direct Case were revised to produce even more conservative estimates presented in the NTCs' Notification Of Intent To Adopt SFAS-106 (submitted December 7, 1992), and in the NTCs' tariff filing.

<sup>30</sup> This cap applies to all active nonmanagement employees and those who retire after January 1, 1992.

kept the TBO costs as low as reasonably possible, and why the full amount of the NTCs' requested TBO exogenous adjustment should be approved.

Moreover, it would be very unfair and unwarranted to deny exogenous treatment and thereby disregard in rates these limited TBO costs. The simple fact is that the NTCs will still incur these costs. If denied recovery by the Commission, our shareholders would then have to absorb the costs. This could lead to pressure on behalf of shareholders for NYNEX to attempt to abrogate its "promises" and take away these benefits in, e.g., dealings with our unions. In this scenario, action by the Commission would have an inappropriate but direct impact on the collective bargaining process. As observed by the Commission in another context: "the Commission has neither the desire or a mandate to interfere in collective bargaining."<sup>31</sup>

In closing, the Commission should evaluate the issue of control in the context of realistic future expectations and reasonable assumptions. Indeed, if LECs and other companies really had control over SFAS-106 accruals, then one might expect zero accruals. But this has not been the case, again pointing out the real constraints operating here.

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<sup>31</sup> Amendment Of Part 81 And 83, Gen. Docket No. 80-87, Order released July 14, 1980, 78 FCC2d 1270, para. 21.

B. The TBO Costs Are Not Included In The GNP-PI

In our annual filing, we relied upon Godwins' original and supplemental studies which have shown that SFAS-106 has a disproportionate effect on price cap LECs such that the majority of additional costs from the accounting change are not captured in the GNP-PI part of the price cap formula.<sup>32</sup> While the OPEB Order found some deficiencies in the Godwins original study,<sup>33</sup> the supplemental study by Godwins submitted by the NTCs in their annual filing fully addressed and resolved the deficiencies identified by the Commission.<sup>34</sup> The evidence submitted by the NTCs showed, among other things:

- Godwins "best estimate" is that only 0.3% of SFAS-106 incremental costs are reflected in GNP-PI and 12.3% might be recovered by a reduction in the wage rate and other macroeconomic adjustments, leaving more than 87.3% of the costs unrecovered.
- Godwins used conservative assumptions at every juncture (i.e., overstating recovery in GNP-PI), e.g. baseline value of price elasticity of demand, labor supply elasticity, direct impact of SFAS-106 on labor costs, etc.
- The Godwins estimate is built upon a sound foundation composed of actuarial and macroeconomic analyses.

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32 As noted in the Designation Order (para. 9): "The LECs based their second-prong showing on two studies: one prepared for the United States Telephone Association by Godwins; and one prepared by National Economic Research Associates, Inc. (NERA)."

33 As noted in the Designation Order (para. 9): "The OPEB Order expressed reservation about the speculative nature and close dependency of results on the initial assumptions...."

34 Again, the Designation Order finds that (para. 29): "The record concerning double counting in the GNP-PI has been enhanced by a second Godwins Study."

- Godwins performed a sensitivity analysis of 648 scenarios posed by the Commission. This analysis showed that even under a "worst case" scenario, 60% of SFAS-106 incremental costs are not recovered absent exogenous treatment. The sensitivity analysis thus confirms the original study's conclusions.
- Even though on a superficial level the Godwins and NERA studies appear inconsistent in their assumptions,<sup>35</sup> they both corroborate the same result: only a small piece of SFAS-106 additional costs will be reflected in GNP-PI.
- The Godwins results are confirmed when tested under an illustrative example using NERA's assumptions.

In sum, we have shown lack of double-count of SFAS-106 incremental costs in the GNP-PI, and the Commission should summarily conclude its investigation on this point.

C. The TBO Is Not Otherwise Double-Counted

1. Intertemporal Double-Count

The Designation Order states (para. 10):

Because pay-as-you-go amounts for OPEBs are already built into the LECs' rates, the GNP-PI portion of the X factor in the PCIs would give the LECs all the funds they need over time to cover these expenses. The immediate recovery of those costs (on an accrual basis) as an exogenous change, and the recovery over time through the GNP-PI portion of the X factor, would result in double counting.

The NTCs continue to be willing to accommodate the Commission's concerns on this point. In line with the conservative nature of our TBO-only request in the Annual Filing (D&J, Sec. 1, p. 60), since the accrual amortization amount for the TBO is fixed, we have offered to subtract each year the GNP-PI minus productivity impact on that amount.

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<sup>35</sup> See Designation Order n. 21.

However, we do take exception to the implicit notion in the Designation Order that exogenous treatment in this case should be denied because the GNP-PI portion of the X factor applied to pay-as-you-go costs would supply adequate funds. The Order ignores the rationale which led to the FCC's adoption of SFAS-106 in the first place. The issue is not whether accrual or pay-as-you-go will supply adequate funds over time -- either method may accomplish that purpose -- but which method better provides for the timing of the recovery. SFAS-106 represents the view that OPEB costs should be recognized as they accrue rather than when they are paid.<sup>36</sup> In short, present ratepayers are expected to fund benefits of employees and retirees who have worked to provide them with services.<sup>37</sup>

## 2. Rate Of Return

The Designation Order (at paras. 11, 29) raises the possibility that the effects of SFAS-106 may be double-counted in the FCC-prescribed interstate rate of return. However, there is no such double-count.

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<sup>36</sup> As stated in the SFAS-106 Summary (p. 2): "This Statement relies on a basic premise of generally accepted accounting principles that accrual accounting provides more relevant and useful information than does cash basis accounting.... Accrual accounting goes beyond cash transactions and attempts to recognize the financial ~~effects of non-cash transactions and events as they occur~~."

Not only did the FCC not consider the costs of SFAS-106 during the rate of return prescription process, but these costs were not known to the FCC or to anyone else at the time. Nowhere in the material submitted to the FCC during the rate of return prescription process is SFAS-106 mentioned, nor does the FCC's rate of return prescription Order reference SFAS-106.<sup>38</sup> Hence, any suggestion that the rate of return prescribed by the FCC already considered the impact of SFAS-106 is unfounded.

Absent some clairvoyant powers, there is no way

values substantially, the FASB proposal so far has caused little stir on Wall Street. Most analysts seem to think that Congress will step in at the last minute, or that FASB will back down, or that the companies themselves will duck out on their promises before the rule goes into effect. Shrugs Lee Seidler, an accounting specialist with Bear Stearns, "It will be a big yawn."<sup>39</sup>

Even recently, the impact of SFAS-106 is not entirely clear according to the investment community. Standard & Poor's has opined that implementation of SFAS-106 will not negatively impact utility ratings.<sup>40</sup>

Regarding a possible impact of SFAS-106 on stock prices, it is unclear how any such impact would be translated into a different rate of return finding, assuming for the sake of argument that there was such an impact. We should consider the impact of stock prices on one of the components of the Discounted Cash Flow (DCF) methodology relied upon by the FCC in its rate of return prescription process. The DCF methodology basically provides that the equity return required by investors can be determined by adding the dividend yield and the expected growth in dividends. The dividend yield is measured by dividing the dividend by the price of the stock

the announcement of SFAS-106), the dividend yield becomes higher. However, we must consider the impact that a negative reaction would have on the other component of the DCF formula, the growth in dividends. Since the growth in dividends is paralleled by the growth in earnings, and the impact of SFAS-106 is presumed to reduce earnings, the growth factor in the DCF formula would decrease. The net result is that the return required by investors, as determined by the DCF formula, remains unchanged. In any case, the FCC has recognized that it is simplistic to assume that a change in stock prices will necessarily lead to a change in expected return.<sup>41</sup>

In a study by Mittelstaedt and Warshawsky --  
which was written a full four months after the introduction of

The risk associated by investors with the costs of SFAS-106 is considered to be a diversifiable risk. That is, there are sufficient differences among the SFAS-106 obligations of American companies, that investors who seek to avoid the risk they perceive to be attendant to SFAS-106 can do so merely by purchasing shares in companies that have a lesser SFAS-106 exposure, or no exposure at all. It is precisely because this risk is diversifiable that portfolio theory maintains that investors do not require a higher rate of return to compensate for it.<sup>43</sup>

Moreover, the FCC has prescribed the interstate access rate of return to provide a fair return to shareholders after compensation for all just and reasonable operating expenses of the business.<sup>44</sup> The Commission has observed that:

rate of return. the percentage expression of financing

3. Productivity Factor

The Designation Order (at paras. 11, 29) raises the issue whether SFAS-106 type costs, i.e. funded Voluntary Employee Benefits Association (VEBA) amounts, are already included in the studies used to derive the price cap productivity factor; and if so, what the result of excluding such effects would be. The Designation Order suggests that a greater reduction of LEC costs in the period studied might have implied a higher productivity factor. However, there is no double-count in this area. First, the NTCs' instant TBO request does not include any funding for VEBAs. Thus, VEBA trusts are inapplicable to this request.

Second, the NTCs have already agreed that since the TBO amount is fixed it need not be subject to the GNP-PI minus productivity factor. Under this approach, the productivity factor on a going-forward basis will not be applied to the TBO amount for retirees only.

Third, in the LEC Price Cap Order, the FCC analyzed many studies, "but none fully and conclusively addressed or answered the specific question of the proper baseline productivity for LECs subject to price caps."<sup>46</sup> In general, the studies consistently ranged between 2 and 3 percent. Adjusting for the minimal amount of funding for VEBAs would not have significantly impacted that range.

The FCC stated that analysis of the productivity issue "involves extremely complex and technical issues of data

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<sup>46</sup> Id. at para. 77.

accuracy, assumptions, necessary adjustments, and statistical methodology." The FCC found that in general long term studies produced lower productivity factors while short term studies produced higher productivity factors; "therefore the selection of an offset requires us [FCC] to exercise judgement." That judgment was used to select a "substantially higher productivity factor than the Commission had originally proposed."<sup>47</sup> Again, if the short-term study had been adjusted for the very small amount of VEBA funding, there would probably have been no difference in the final outcome once the FCC applied its judgment.

In sum, the FCC acknowledged in the LEC Price Cap Order (para. 77) that none of the productivity studies were entirely conclusive, but rather those studies provided a range of values. The Commission applied its judgment to select the productivity factor from that range, but did not give any indication of any adjustment or effect relating to SFAS-106 type costs. It would be improper now, in effect, to substitute a post hoc rationale for the FCC's productivity factor decision.

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Therefore, the NTCs' exogenous cost adjustment for the TBO under SFAS-106 is free of double-count from the GNP-PI and other elements of the price cap formula.

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<sup>47</sup> Id. at para. 78.

IV. CONCLUSION

The FCC should approve the NYNEX Telephone Companies' proposed exogenous adjustment (approximately \$12 million) for the incremental costs of implementing SFAS-106 for a portion of OPEBs -- i.e., the TBO for current retirees only. We have met the Commission's control and double-count tests for exogenous treatment; and have presented a very reasonable, conservative request that is fully consistent with the Commission's rules.

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EXHIBIT 1  
APPENDIX A

CC DOCKET NO. 93-193;  
NYNEX TELEPHONE COMPANIES'  
DIRECT CASE (JULY 27, 1993)

This Appendix responds to the Designation Order's request (at para. 105.1) for demographic data for the LECs' active and retired work force. Specifically, the companies are directed to:

provide evidence of and describe the ranges of data on the age of the workforce, the ages at which employees will retire, and the length of service of retirees presented by their actuaries and used by the companies

EXHIBIT 1  
APPENDIX A

- 2 -

The relative shares of SFAS-106 and "pay-as-you-go" costs were also revised to reflect updated active and retired employee information. This change had virtually no impact on the NTCs' incremental OPEB costs, since the SFAS-106 and pay-as-you-go amounts increased at almost identical rates. In summary, although there have been some changes in the estimated overall SFAS-106 costs and the allocation methodology since the tariff filing, the change in incremental OPEB costs is immaterial.

PERSONNEL INFORMATION

EMPLOYEE CENSUS DATA AS OF JANUARY 1, 1992

■ Active Employees

	<u>Number</u>	<u>Average Age</u>	<u>Average Years of Service</u>	<u>Average Entry Age</u>
Management				
Male	14,281	43.2	18.4	24.8
Female	<u>10,823</u>	41.1	17.1	24.0
Total	25,104	42.3	17.8	24.5
Non-Management				
Male	26,997	40.3	15.6	24.7
Female	<u>25,639</u>	40.6	14.8	25.8
Total	52,636	40.4	15.2	25.2

■ Service Pensioners

	<u>Average</u>	<u>Average Years</u>	<u>Average Age</u>	<u>Avg. Service</u>
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EXHIBIT 1  
APPENDIX B

CC DOCKET NO. 93-193;  
NYNEX TELEPHONE COMPANIES'  
DIRECT CASE (JULY 27, 1993)

This Appendix responds to the Designation Order  
directive (at para. 105.1) for

the LECs to provide pertinent sections of their  
employee handbooks, contracts with unions, and other  
items that include statements to the employees  
concerning the company's ability to modify its  
post-employment benefits package.

INDEX TO APPENDIX B

The enclosed excerpts from the documents listed below respond to the Commission's information request.

- Attachment 1: NYNEX Management Medical Plan And Summary Plan Description
- Attachment 2: Summary Plan Description Of NYNEX Management Dental Plan
- Attachment 3: NYNEX Management Group Life Insurance Plan And Summary Plan Description Of NYNEX Management Survivor Benefits Program
- Attachment 4: NYNEX Legal Information Summary Plan Description (Management)
- Attachment 5: NYNEX Medical Expense Plan (Non-Management) And Summary Plan Description
- Attachment 6: NYNEX Non-Management Dental Expense Plan And Summary Plan Description
- Attachment 7: NYNEX Non-Management Group Life Insurance Plan And Summary Plan Description Of NYNEX Survivor Benefits Program

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[REDACTED]

[REDACTED]

## MANAGEMENT MEDICAL PLAN

### A. Undertaking.

1. The Company undertakes to make available the Management Medical Plan (hereinafter called the "Plan") to Employees, Retired Employees (as such terms are defined in Section B), and certain of their dependents which will pay benefits in accordance with the terms hereof.
2. The Plan benefits will be provided under contracts between the Company and one or more Administrators selected by the Company. Such contracts shall include the substance of Sections B through P, and shall be administered by the respective Administrators, which will determine benefits and other questions arising thereunder. The contracts necessarily will conform to applicable state or federal laws. If any of the provisions of the Plan must be modified because of state laws, such modification will be made by the Company.
3. The Company and each other Employer reserve the right to terminate or amend the Plan.

### B. General Definitions.

1. "Administrator" - The insurance company or companies or other administrator(s) selected by the Company to provide certain administrative services under the Plan.
2. "Ambulatory Surgical Facility" - An institution, either freestanding or as part of a Hospital, with permanent facilities that is equipped and operated for the primary purpose of performing surgical procedures in which a patient is admitted to and discharged from such facility within a brief period (generally not to exceed 24 hours). An office maintained by a Physician for the practice of

(2) A part-time employee who has completed a Term of Employment of six months and who is scheduled to work less than 17 hours per week may enroll and shall pay the full premium, with no company contribution, towards the cost of the Option and Dependent Status he or she chooses. The Employee will be covered under this Plan beginning with the first of the next calendar month after receipt of such enrollment application by the Company.

(B) Certain Employees Hired Before 1981. A regular management Employee on the active payroll of the Company as of December 31, 1980, who works part-time on or after January 1, 1981, without a break in Term of Employment, shall continue to be covered on the same basis as a regular full-time Employee.

(d) Coverage for Retired Employees

A Retired Employee will continue to be covered by this Plan, and shall receive a company contribution toward the cost of the Option and Dependent Status in which he or she is enrolled. The Retired Employee shall be eligible by paying the difference between the premium and the company contribution, if any. Retired Employees eligible for Medicare and their Dependents will be eligible for coverage under Option B only.

2. Dependents of Employees and Retired Employees.

(a) For any period during which an Employee or Retired

the term "coverage" shall mean coverage under the Plan other than COBRA coverage.

2. Employees.

An Employee's coverage shall cease at midnight on the earliest of the following dates:

- (a) The day the Employee dies;
- (b) The last day of the month in which the Employee becomes a non-management employee of the Employer;
- (c) The day before the day on which the Employee becomes covered under an HMO;
- (d) The last day of the month for which the Employee fails to pay any premium which is required (pursuant to any other provision of the Plan) as a condition of coverage;
- (e) The last day of the month in which the Employee begins an approved leave of absence (other than a family care leave of absence);
- (f) The last day of the month in which the Employee requests in writing that coverage cease, provided that the Employee has attained age 65 on or before such day;
- (g) The day the Plan is discontinued;
- (h) The day before the day on which the Employee becomes a Retired Employee or becomes eligible to receive benefits under one of the NYNEX Companies' long-term disability plans, but only if such Employee elects (in lieu of the coverage otherwise provided to